

QUARTERLY REPORT

August 1, 2004 to October 31, 2004

Project Title

Montana Department of Transportation (MDT)
Determine Current Rates of Motor Fuel Tax Evasion in the State of Montana

Principal Investigator

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Research Assistants

The work performed under this contract has been performed by the Battelle Memorial Institute with the assistance of our subcontractor, Montana State University.

Introduction

This first quarterly report covers the period beginning August 1, 2004 and ending on October 31, 2004. During the last quarter, the research team focused primarily on activities outlined in Tasks 1 (kickoff meeting, literature review and enforcement/compliance activities) and 2 (comparative assessment of neighboring states'/provinces' enforcement programs), as described below in the Work Progress section of this report. The next section provides an overview of the project objective. The report also provides an overview of the progress completed to date and a projection of work to be performed in the next quarter. Finally, the report compares anticipated budget/work completed to the project schedule.

Project Objective

The primary objective of the research project is to determine the extent and underlying reasons for motor fuel tax evasion in Montana. The project will also generate recommendations concerning where best to focus enforcement efforts and make changes to tax code to close the gap between total tax liability and actual tax collections in Montana. The specific objectives of the project are to:

- Critically assess administrative and enforcement characteristics of border state practices, identify how these characteristics have traditionally correlated with certain types of evasion and compare these programs to Montana State practices.
- Identify evasion techniques and note administrative, enforcement and legislative strategies used to curtail motor fuel tax evasion.
- Identify and examine data that could be used to assist Montana in measuring motor fuel tax evasion.
- Develop and demonstrate a methodology for estimating state motor fuel tax evasion.
- Develop recommendations for making changes to the current administrative, enforcement and legislative framework established for the motor fuel tax program in Montana and perform benefit-cost analysis to rank these proposed changes based on the computed benefit-cost ratio for each proposed programmatic change.

Work Progress

Work completed to date has focused on the activities outlined under Task 1, including attending a kickoff meeting, presenting an overview of the research program at the meeting, preparing minutes from the kickoff meeting, completing a literature review and examining historical changes to the federal excise tax program. Additionally, the research team worked on Tasks 1c and 2 by preparing a list of contacts in neighboring states and provinces, submitting an interview protocol, receiving comments on the protocol and incorporating them in a revised set of questions and conducting interviews with representatives from four neighboring states: Washington, Idaho, North Dakota and Utah. A summary of each activity performed, along with percentage of work completed by task, follows:

- Task 1 – Kickoff Meeting, Literature Review, Enforcement/Compliance Activities
 - Prepared a presentation outlining the project work plan and delivered the presentation at the kickoff meeting.
 - Attended the project kickoff meeting in Helena, Montana.
 - Addressed issues raised during the kickoff meeting by technical panel members and submitted a revised work plan.

- Prepared meeting minutes.
- Prepared a literature review. The literature review highlights: evasion studies, fuel reporting and tracking systems, federal and state motor fuel excise tax revenue forecasting models, studies examining motor fuel tax administration and enforcement programs, data sources and analysis of tax codes.
- Examined current and historical federal activities aimed at addressing the motor fuel tax evasion issue. This report is designed to document federal activities, changes in enforcement programs (e.g., taxation of alternative motor fuels, moving the point of taxation to the terminal rack) and the impacts that these changes have had on enforcement and compliance.
- Performed an initial scan of the literature, including studies examining evasion and methods used to curtail evasion, noting the evidence presented within these studies.

Task 1 represents 16.8% of both the total work effort and the budget. Task 1 is 75% complete.

- Task 2 – Impact of Enforcement Programs
 - Submitted an interview protocol to technical panel.
 - Revised interview protocol based on input from the technical panel.
 - Identified contacts in each of the neighboring states and provinces targeted for examination.
 - Conducted interviews with representatives of the states of Washington, Utah, Idaho and North Dakota.

Task 2 represents 10.9% of both the total work effort and budget. Task 2 is 25% complete.

- Task 3 – Analysis of Tax Codes, Legislation
 - Scanned relevant literature and notes from interviews conducted in support of this project as well as those conducted in support of the National Cooperative Highway Research Program (NCHRP) study of motor fuel tax evasion.
 - Noted significant tax code issues identified within the literature and interview notes.

Task 3 represents 8.9% of both the total work effort and budget. Task 3 is 10% complete.

No work has been performed on Tasks 4-10.

Issues

To date, no significant issues or problems have been identified. There was one small issue concerning project verification with potential interviewees; however, the MDT project manager authorized Battelle to share the cover page of the contract with representatives of neighboring states and provinces requesting such verification. The cover page was deemed to provide adequate verification.

Major Accomplishments or Discoveries

The Battelle Team completed an extensive literature review that confirmed that Montana is not alone in its interest in curbing motor fuel tax evasion. Individual states' concerns over motor fuel excise tax evasion has generated a concerted research effort over the past couple of decades, resulting in new methods for measuring evasion and techniques for curtailing evasion. The identified research has focused predominantly on measuring the extent of evasion and finding methods to increase compliance at both the state and federal levels. Relevant literature and information examined for the literature review fit into the following categories: studies measuring extent of evasion, sources of and studies that examine data, sources of motor fuel consumption and revenue forecasting, motor fuel excise tax codes, literature relating to tax administration and enforcement and methods of curtailing evasion.

The literature indicates that major policy changes (i.e. moving the point of taxation and diesel fuel dyeing) have had significant and measurable impacts on compliance. These changes have been largely adopted by states. The treatment of alternative fuels, which have become increasingly relevant in recent years, has become a new policy initiative area as states grapple with this issue in an effort to curtail the erosion of gasoline tax revenue and increase motor fuel excise tax compliance. However, the attention of the battle against fuel tax evasion has also turned to more subtle and incremental changes in administrative policy. One significant issue increasingly referenced in the literature is uniformity between state programs. Through the work of the Federation of Tax Administrators (FTA), individual states and other entities, a collection of best practices and uniformity principles have been set forth and are being used to guide efforts to combat motor fuel tax evasion through enhanced uniformity. At this point, the biggest effort at the state-level appears to lie in moving state programs toward the ideal policies set forth in the FTA Uniformity Project's 11-point plan.

The interviews conducted to date have been extremely illuminating in the identification of factors that contribute to evasion. The Battelle Team has conducted 18 interviews with state tax administrators and industry representatives. This work was performed in support of multiple contracts but the lessons learned are applicable in Montana. More specifically, the Battelle interviewers heard evidence suggesting that the following variables had a significant impact on evasion:

- Treatment of blending fuels;
- The use of electronic systems to track motor fuel shipments and produce discrepancy reports;
- The level of resources expended to enforce programs and audit industry;
- The focus of the enforcement efforts (e.g., in-office versus field operations);
- The point of taxation;
- The geographic proximity to low-tax states;
- Sharing of import/export data with neighboring states;
- The presence of agreements with Native American Tribes;
- Access to US Customs data;
- Lack of uniformity between tax systems in neighboring states;
- Ability to use seizure laws to aid motor fuel tax enforcement/collections;
- The ability to suspend operations when detecting fraudulent activity;
- The impact of dedicated legal staff to the prosecution of motor fuel tax evasion;
- Dedicated motor fuel tax enforcement personnel versus embedding motor fuel excise tax collection within larger taxing/revenue agencies;
- Fine and penalty levels;
- Prevalence of roadside inspection and tank dipping;
- Coordination between states and between agencies within states;
- Ability to deny licenses based on outstanding tax liability or fraudulent activities conducted in other states;
- The licensing requirements for entities that obtain tax-free motor fuel;
- Treatment of refunds;
- Diesel fuel dyeing practices; and
- Public awareness campaigns.

The evidence presented in the interviews has been supported in some cases with additional data transferred post-interview. The information collected to date will form the foundation of the comparative assessment of state programs, the methodology used to model motor fuel tax evasion and the recommendations we provide for closing gaps in Montana's motor fuel tax program.

Work Projection

During the next quarter, ending January 31 of 2005, we plan to perform the following activities:

- Complete the Task 1c examination of enforcement/compliance activities.
- Conduct interviews with all neighboring states and provinces to gather data on their motor fuel tax compliance and enforcement programs.
- Complete the Task 2 comparative analysis of enforcement programs.
- Complete the Task 3 analysis of tax codes, administrative rules and motor fuel tax legislation.

- Begin work on the Task 4 industry enforcement activities analysis by identifying contacts and conducting interviews with industry representatives.
- Begin work on Task 5 by identifying data sources and collecting some of the data required to produce GIS maps of the region's motor fuel distribution system.

Schedule

The project is slightly ahead of schedule and under budget. As shown in Figure 1, we targeted Task 1 for 66% completion, Task 2 for 25% completion and Task 3 for 10% completion at the end of this quarter. Thus far, Task 1 is 75% complete and Tasks 2 and 3 are on-schedule at 25% and 10% completed, respectively.

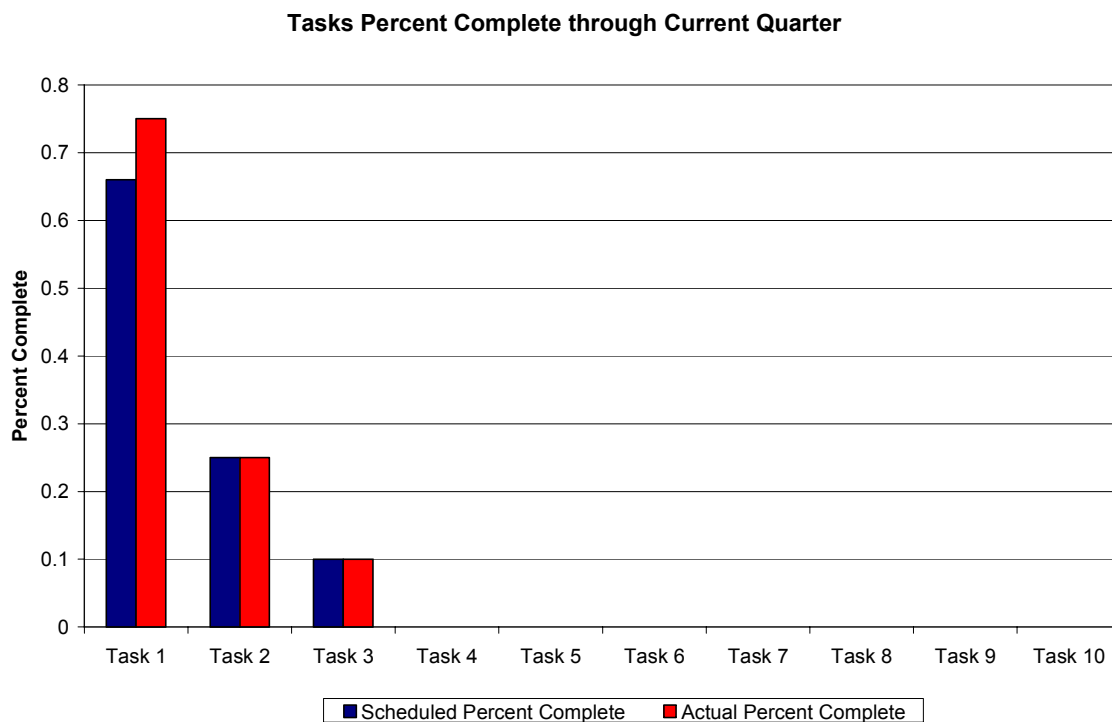


Figure 1 – Work Progress through October 31, 2004.

Budget

The project budget identified roughly \$28,000 for the first quarter of the research plan but only \$20,000 was expended. The amount expended to date, however, does not account for recent sub-contractor activity, which has not yet been invoiced. With that noted, the sub-contractor invoices are anticipated to bridge some but not all of the gap between the budgeted and expended amounts, thus leaving the project under budget.

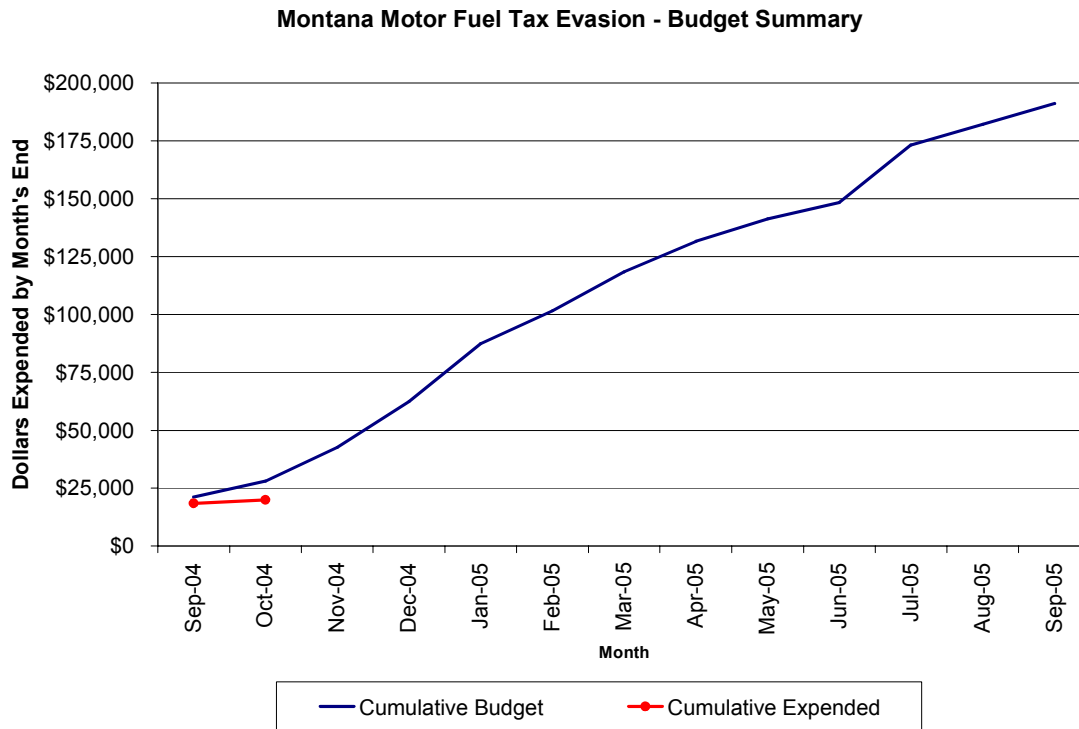


Figure 2 – Projected and Actual Expenditures through October 31, 2004.

Budgeted and Projected Expenditures – State and Federal Fiscal Years (SFY and FFY) 2004 and 2005

Table 1 presents an analysis of the project budget, including the total project budget, total invoiced through October 31 of 2004, the remainder of the project budget, total expenditures through SFY and FFY 2004 and projected expenditures through SFY and FFY 2005. Costs for all tasks will be incurred in the State of Montana's FY 05 (July 1, 2004 – June 30, 2005), with the exception of a portion of those incurred on Tasks 8 and 9, and all of Task 10. Those tasks will carry into the State of Montana's FY 06 (July 1, 2005 – June 30, 2006). The remainder of the unexpended balance (\$171,517) will be totally expended during FFY 2005 (October 1, 2004 – September 30, 2005).

Table 1 Budgeted and Projected Expenditures for State and Federal Fiscal Years (SFY and FFY) 2004 and 2005.

Budget Items	Budgeted/Projected	Actual
Total Budget	\$191,079	\$191,079
Total invoiced through October 31, 2004	\$28,065	\$19,946
Total project budget remaining as of October 31, 2004	\$163,014	\$171,517
Total expenditures through SFY 2004	0	0
Total expenditures through FFY 2004	\$28,065	\$19,946
SFY 2005 expenditures	\$148,356	\$19,946 ¹
FFY 2005 expenditures	\$180,499	\$1,445 ¹

¹Actual amounts represent those expended within SFY and FFY 2005 through October 31, 2004.